ORD MINNETT
PRIVATE WEALTH

Ords Monthly

Ord Minnett Research July 2011

Growth and Sentiment

Rally round

Share markets rebounded on the passing of austerity measures through the Greek parliament, a critical step in the debt-laden country's efforts to secure a financial lifeline from the European Union and the International Monetary Fund. It would appear that the least problematic scenario for the euro debt situation is playing out. That is, Greece receives its much needed bailout, while private sector interests, mostly French and German banks, agree to let Greece repay some of its debt more slowly.

While this provides Greece and the broader euro area the necessary breathing space, it does not necessarily provide a permanent solution. We could easily be back at the same place in a year's time, if Greece continues to under-deliver. At that point, it is possible that policymakers in the rest of the region will decide that a formal restructuring is the right thing to do.

Recent weeks have brought hints of a bottoming in the global growth slowdown, an obvious precondition for our view of a rebound over the balance of 2011. Fears of a hard landing in China have eased, while a strong bounce in the Japanese economy is starting to feed through to other major economies.

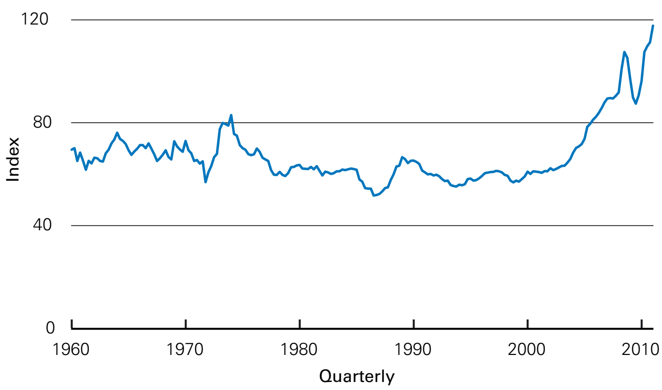
While the local economy continues to advance (the local terms of trade illustrates this nicely), global conditions have dominated local investors' sentiment. The signs, however, indicate that the upcoming reporting season should deliver a timely reminder that corporate Australia is still very profitable and that it could deliver a helpful boost to investor sentiment.

In this edition we consider the impact the release of strategic oil reserves will have on the price of oil and how Santos's share price could benefit. We also revisit the local banks, a foundation stone bedrock of the local economy. Lending growth has slowed, but this is well reflected in share prices that are offering compelling yields.

The signing of a definitive agreement between Telstra and the Commonwealth Government for the sale of its fixed line network is a significant milestone towards a final resolution on the national broadband network. We step through the implications for Telstra.

Newcrest has also announced the sale of some non-core mines, allowing it to focus on its major operations. Our article on page 6 discusses the thinking behind our positive recommendation on Newcrest.

Australia's terms of trade



Source: RBA, Data is seasonally adjusted

Investment strategy

Looking for a better half

- The share market has proved resilient in the face of a number of negative factors, having delivered a total return of 11.7% (capital gain of 7.1% plus yield of 4.6%) for the 2011 financial year.
- A quiet confession season (limited so far and generally company-specific) supports the idea that profitability for ASX-listed shares remains solid.
- We stick with a year-end index target of 5,000. Hold **BHP Billiton, Rio Tinto, ANZ, National Australia Bank, Wesfarmers, Lend Lease, Amcor, Orica, UGL, CSL, AGL Energy and Santos** to reach it.

Given the amount of negativity that investors have had to cope with over the last few months – natural disasters, sovereign debt, patchy economic data, uncertainty over government policies – the local market has displayed admirable resilience. This ability to absorb shocks gives us confidence that the market can move towards our calendar year-end target of 5,000 for the S&P/ASX 200 Index, especially given evidence that these factors are proving temporary or that their implications are limited.

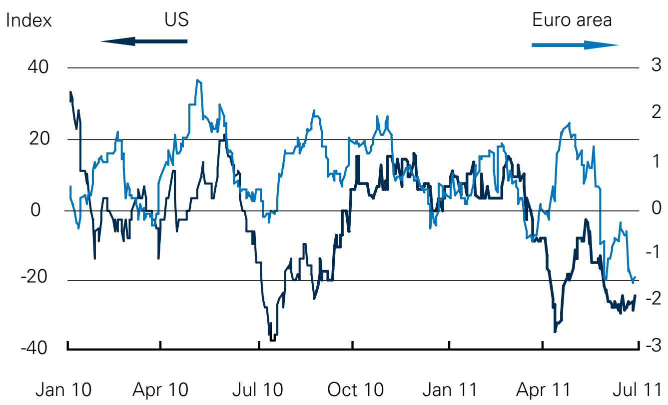
Locally, we interpret the fact that only a handful of companies have downgraded expectations in the last couple of months as a positive sign for the upcoming reporting season. Reductions in earnings guidance tended to be isolated to particular sectors rather than broad based. In resources Woodside announced capital expenditure over-runs at its Pluto project while Newcrest trimmed production estimates. As evidence of problems with local manufacturing, BlueScope and OneSteel reduced guidance. Airlines have struggled with higher oil prices and the currency. Discretionary retailers, such as Myer, are finding current conditions a challenge. Global natural disasters have squeezed QBE's insurance margins.

Profit growth during the financial year just ended for Australian stocks should settle between 15% and 20%. This would be a solid result and provide an important marker on which to value the Australian market. August reporting season could be one of the factors that helps the S&P/ASX 200 index reach our December year-end target of 5,000. In reaching that figure we'd include the following stocks in a core portfolio – BHP Billiton, Rio Tinto, ANZ, National Australia Bank, Wesfarmers, Lend Lease, Amcor, Orica, UGL, CSL, AGL Energy and Santos.

Global economic sentiment bottoming out

Sentiment around economic conditions appears to be at a low point, as evidenced by the chart below of economic surprises showing a bout of data falling short of expectations. There is little doubt that we are seeing a global slowing in the pace of growth. This occurs regularly in the path of business cycle expansions, as strong advances followed by retreats are normal occurrences. While this pattern is expected, the causes of the uneven pace of growth often vary. This time the causes of temporary slowness have been higher oil prices and supply stoppages for key machine parts coming out of a shaken Japanese economy.

Economic Activity Surprise Index



Source: Ord Minnett Research

It is an important feature of these bouts of negative economic surprises historically that market participants adjust their expectations downwards quickly so that data starts to provide positive surprises. Indeed, this is starting to occur. Activity data from the US has picked up, coming after Japanese data has delivered positive surprises for several weeks.

The US job market is a critical factor to ensure the economy there remains on track. Jobs, particularly in the private sector, are rising in number, with month-on-month and year-on-year increases, albeit at a moderate pace at this point in the recovery. It also important to recognise that the US economy can grow without a significant amount of new jobs being created if the number of hours worked are also factored in. They're higher than they were a year ago, and when multiplied by average hourly wages (also higher than a year ago), the result has a similar effect to the creation hundreds of thousands of new jobs.

The Greek parliament's passing of the latest austerity package in order to secure a financial lifeline from the European Union and the International Monetary Fund has helped to avert a disorderly default process. In effect, policymakers have bought more time, so we expect the situation to fade from the headlines over the coming weeks.

However, it is easier to approve an austerity package than to implement it. Indeed, the fiscal targets facing Greece are so challenging that restructuring fears are likely to flare up again later this year, or early next year. The degree of contagion at that point will depend on how well European Union leaders use the time they have bought. If Greece's creditworthiness has not improved, then another more drastic strategy is likely to be put in place. Certainly, the European debt problems are a great deal away from resolution. For now, the best measure of contagion risk, the yield on Spanish government bonds, indicates any broader crisis has been averted.

For a while now, investors have been wary that Chinese policymakers were falling behind in their efforts to control an overheating economy and would be forced to suddenly stamp heavily on the brakes and significantly slow the economy. To everyone's relief, Chinese policy tightening has combined with the recent fall in oil and food prices to bring headline inflation under control. Add to this better production data and investors are starting to gain increasing confidence in a soft landing.

The expected peak in Chinese inflation does not imply that China or other emerging markets are at the end of their tightening cycles. Instead it implies a slowing in this process, which is a necessary and responsible way of managing economies that are experiencing robust growth rates. This has been, and will continue to be a feature of the much longer industrialisation cycle that is underway in these major emerging economies.

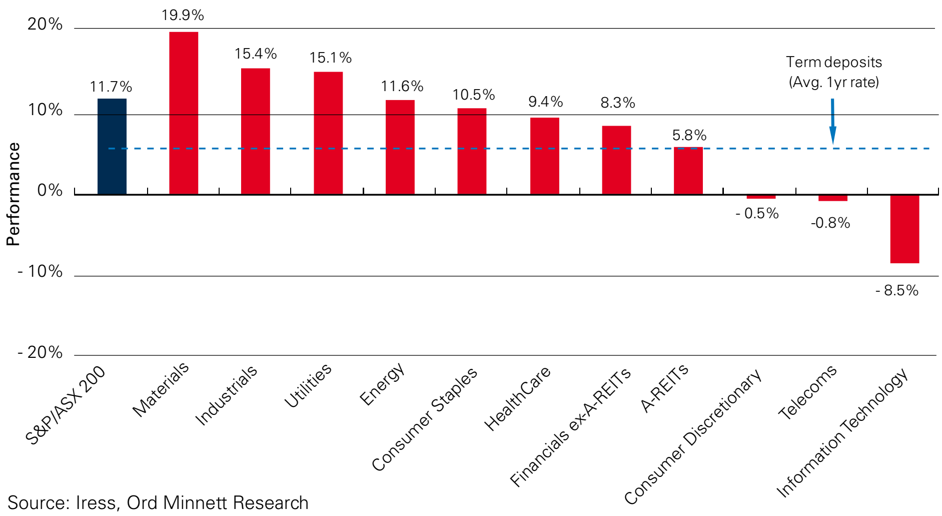
Market delivers 11.7% total return over FY11

While markets have been choppy over the last few months, it's worth considering the returns from the Australian market over the 2011 financial year. The S&P/ASX 200 index produced a capital gain of 7.1%, having started the financial year at 4,301 and finishing at 4,607. When dividends are included the market produced a total return of 11.7%. In the chart below we have included the average one-year term deposit rate during the financial year of 6.04% as a benchmark, indicating the market outperformed by 5.7%.

The best performing sectors on a total return basis were Materials (led by the major mining companies), Industrials (strong performances from Brambles, QR National, Transurban) and Utilities (boosted by large dividends). The worst performing sectors were Information Technology (a large drop in Computershare), Consumer Discretionary (structural and cyclical factors have weighed on discretionary retailers) and Telecoms (Telstra's hefty dividend went some way to offsetting the capital loss).

This overall result reminds us that shares remain a key component of any investment portfolio and can perform well despite media headlines to the contrary.

S&P/ASX 200 Index Performance over the 2011 Financial Year (Total return basis)



Source: Iress, Ord Minnett Research

Banking sector

Yield to me

Since August 2010, we have been saying that the Australian banking sector would trade within a range and since then banks' valuations have tested our theory. Banks' share price performance has hit the floor of our range five times in the last 10 months, but has always been able to get 'back up off the canvas'.

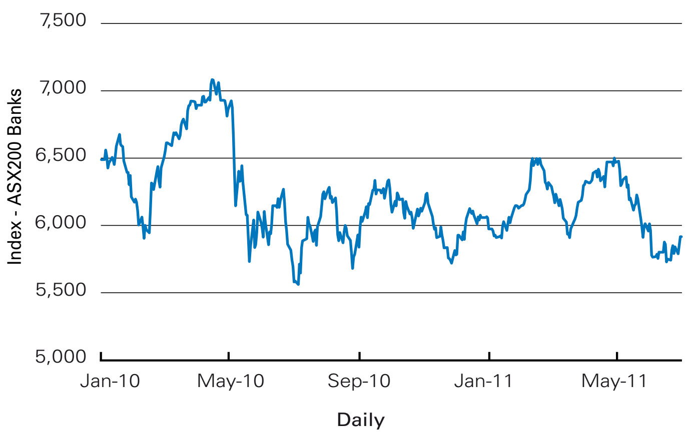
With the broader market sell-off since early April 2011, we again find valuations at the floor. Will the sector bounce back, or will it be different this time?

While dividend yields of around 6.5% have provided valuation support since August 2010, since April this year, yields have been drifting beyond 7% and have still not been sufficiently attractive to support banks' historical 'safe haven' status.

Relative to history, and especially when compared to the 10-year bond yield, Australian bank dividend yields appear attractive at first glance. Equities and bonds are closely connected, with the fortunes of the equity market highly correlated with the 10-year bond yield, which is currently 5.2%. We believe that monetary policy adjustments to control inflation will be gradual because the global recovery is taking longer than expected. In other words, growth expectations are lower, not just for the global economy, but also for Australia.

The prospect of a lower-growth domestic environment is the key reason why Australian bank dividend yields are now at high levels. But does this mean they are attractive or do they simply reflect fair value? While bank yields appear to trade cheaply relative to bonds, we consider this to be a reflection of lower expected growth rates – from around 7% over the last decade, to about 4% today. With global regulatory changes, tight funding profiles, and more importantly, high domestic household debt levels (where households are now targeting debt reduction over consumer spending) and low demand for business credit, we think this is justified.

Australian banks have range traded for some time



Source: Iress. Chart measures the S&P/ASX 200 Banks Index

Big Four Fundamentals – 2011 Financial Year

Bank Recommendation	Price $	Yield (Franking) %	P/E (x)	Forecast EPS Growth (FY11 to 12) %
ANZ (Accumulate)	21.98	6.6 (100)	10.3	4.2
CBA (Hold)	51.85	6.2 (100)	12.3	6.7
NAB (Accumulate)	25.19	6.9 (100)	10.1	7.6
WBC (Hold)	22.00	7.0 (100)	10.6	4.3

Source: Sources: Iress, Ord Minnett Research.

So while bank dividend yields are at historical highs, growth expectations are at historical lows. On the positive side, a lower growth environment leads to higher capital retention by banks. Dividends therefore have the potential to be maintained at higher payout ratios to potentially mitigate any adverse valuation impacts from near-term earnings risk. Higher yields may simply be 'the new normal' in the current low growth environment. While valuations are supportive, thereby limiting further downside (given growth prospects are already subdued), a catalyst to move the sector materially higher may prove elusive.

In the near term, banks' performance will rely on what happens in global debt markets – and domestic issues – the perception that consumer discretionary is vulnerable if domestic interest rates increase.

As to the domestic market, housing lending continues to grow in the mid-single digits, +5.2% for the three months to the end of May (on an annualised basis). Of the major banks, NAB (+15.3%) continues to grow strongly in housing credit, followed by Westpac (+5.8%), CBA (+5.3%) and ANZ (+3.5%). NAB's performance remains strong following the launch of its UBank subsidiary's new variable rate mortgage of 6.59%. For May, housing lending market share for NAB increased to 15.4%, CBA's share declined to 28.0%, while ANZ's and Westpac's shares sit at 14.3% and 26.5% respectively.

Business credit growth remains weak at +0.8% on a three-month annualised basis (NAB +4.0%, ANZ +2.4%, WBC +1.3%, CBA -2.9%). Business lending market share for NAB and ANZ increased to 22.0% and 16.6% respectively. CBA's declined to 20.6%, largely due to weaker lending to government. Westpac's business lending market share declined slightly to 15.2%.

Telstra Corporation and the NBN agreement

Progressing in the queue

Recommendation: Accumulate (High risk) ($2.89)

The Commonwealth Government and Telstra announced in June that they had signed the definitive agreement that will see Telstra sell its existing fixed lines into the country's national high-speed broadband network. We believe this is a significant milestone towards a final resolution.

Key steps – The next steps will include an ACCC review of Telstra's separation undertaking and migration plan, and the vote by Telstra shareholders, scheduled to take place at an Extraordinary General Meeting, to be held in conjunction with the Annual General Meeting on 18 October. We see limited risk on either of these issues.

The negative – A principal negative point is the $2 billion in costs (on a net present value basis) to Telstra associated with the agreements. This came as a surprise. We note, however, that the NBN costs should be contained within a 1% range of total operating costs, largely manageable in the context of Telstra's planned overall costs and capital expenditure.

The positives – The new disclosure and further details provided have enabled a more detailed understanding of the NBN agreements. As such it helps to cement the $9 billion net present value compensation figure. We believe Telstra has adequately mitigated the risks associated with a change in government or policy. We estimate that a potential cessation of the NBN roll-out by 2014 would trigger a $3 billion+ liability payable by the Commonwealth Government to Telstra under the Infrastructure Lease agreement. In our view this is a sufficiently dissuasive penalty.

Valuation – Our June 2012 price target and valuation for Telstra is $3.15. While noting the stock's recent strong out-performance, amidst current market volatility we believe Telstra continues to offer an attractive dividend yield whose sustainability is reinforced by the details provided in the announcement. We maintain an Accumulate recommendation.

Major upcoming milestones - Following the definitive agreement, a number of major milestones remain for Telstra on the way to final approval:

- ACCC review of Telstra's structural separation undertaking and migration plan
- ATO private tax rulings, confirming that the ATO will consider the payments to Telstra as assessable income
- Notice of Extraordinary General Meeting & Explanatory Memorandum (including Independent Experts' report) expected one month before shareholder vote – mid September
- Telstra shareholders vote on the NBN Definitive Agreement (vote requires a simple majority to pass). Held in conjunction with AGM on 18 October.

Any risk around the ACCC review?

The short answer is we don't believe so. While not minimising the issues that the ACCC might raise as part of its review of Telstra's structural Separation Undertaking, we believe comments by the ACCC to date indicate:

- The ACCC sees the NBN as delivering a step function change in terms of broadband for consumers in Australia
- The ACCC believes that the structural separation of Telstra is likely to deliver the best competition outcome for consumers in Australia compared to other models.

As such, the ACCC will likely be pushing for stronger interim measures on Telstra. The ACCC views the NBN and Telstra's structural separation as delivering the best outcome for competition in the Australian telecom market.

Any risk around the shareholders' vote?

Likewise, we believe it is reasonably unlikely that the Definitive Agreements would be voted down by shareholders. With around two-thirds of the register held by institutional investors (the balance is retail), we believe Telstra's shareholders would be well aware of the risks attached to voting down the Definitive Agreements. We also believe that institutional investors collectively have no appetite to revisit the alternative scenarios to the current negotiated outcome.

Telstra Corporation

Year to June	'10A	'11F	'12F
Norm NPAT ($M)	3857.8	3281.3	3476.5
Norm. EPS (c)	31.0	26.4	27.9
Norm. P/E (x)	9.4	11.1	10.5
Dividend (c)	28.0	28.0	28.0
Net Yield (%)	9.6	9.6	9.6
Franking (%)	100.0	100.0	80.0

Source: Ord Minnett

Newcrest Mining (NCM)

Set on a heart of gold

Recommendation: Accumulate (Medium risk) ($37.71)

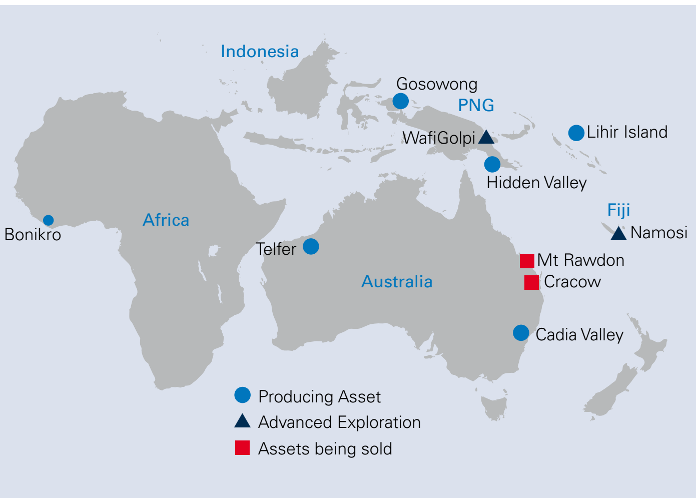
Australia's biggest listed gold producer Newcrest Mining announced in June that it will sell its 70% interest in the Cracow goldmine and its 100% interest in the Mt Rawdon project, both in Queensland, to a new company formed by the merger of gold producers Catalpa Resources and Conquest Mining (announced coincidentally). Newcrest will receive shares in the merged entity as consideration for its assets, equating to a ~33% stake following a proposed ~$150m equity raising by the Catalpa/Conquest entity. This gives Newcrest the opportunity to participate in any upside in the combined group, though we see a sell-down/exit of the stake at some point as the most likely outcome. We believe the transaction is value-neutral from Newcrest's perspective. The deal does, however, highlight Newcrest's continued shift towards focusing on fewer large, low-cost, long-life deposits such as Telfer, Cadia Valley, Lihir and Wafi-Golpu (refer to map below). This lessens the distractions for a management team focused on driving more significant growth levers throughout the business.

We have used this announcement, the recently revised production guidance, and our own updated currency and commodity price assumptions to adjust our earnings forecasts. As a result of these adjustments we have cut FY11 earnings by ~4% and production estimates by 2% due to one-off issues at Lihir Island. We assume this is an isolated event, so the impact on our valuation is minimal, falling 0.5% to $27.62.

We think Newcrest offers compelling value with our price target ($49.00 or 1.75x price/valuation adjusted to December 2011) implying around 30% upside against the current share price. We see this transaction as evidence of a subtle change in focus at the company and sense that there are further opportunities for portfolio restructuring beyond the current measures. We also believe that a commitment to a North American listing could be a positive catalyst. Notwithstanding current foreign exchange headwinds and lack of upward momentum in the gold price, we believe there are enough company-specific drivers for the shares to do well over the next year.

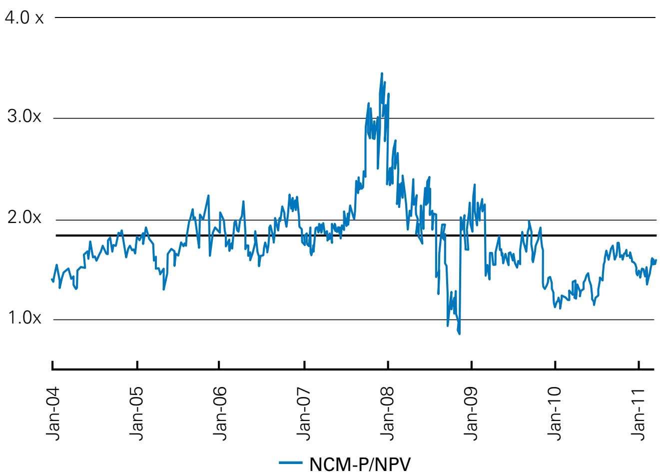
Further on valuing Newcrest, using a measure of Price/Valuation is a traditional method of analysing gold mining companies with most major international firms trading around a ratio of two times. Historical trends are also important in identifying buying opportunities in individual stocks. As evidenced from the chart below, Newcrest shares are currently in value territory based on historical trends and relative to its global peers.

World Class Asset Portfolio



Source: Newcrest, Ord Minnett

Newcrest's historical Price/Valuation trading range



Source: Ord Minnett estimates, Bloomberg

Newcrest Mining

Year to Jun	'10A	'11F	'12F
Norm NPAT ($M)	763.7	1075.1	1346.3
Norm. EPS (c)	157.9	140.5	175.9
Norm. P/E (x)	23.9	26.9	21.4
Dividend (c)	25.0	35.0	45.0
Net Yield (%)	0.7	0.9	1.2
Franking (%)	0.0	0.0	100.0

Source: Ord Minnett

Energy sector

Playing the reserves

The International Energy Agency (IEA) recently decided to release 60 million barrels of its member countries' strategic petroleum reserves – only the third time it has done so since the agency was founded in 1974.

We see weakness following this announcement as an opportunity to increase holdings in Santos (Buy – medium risk, $13.54) our preferred oil and gas stock. Please contact your adviser for further information on Santos.

The IEA's strategic petroleum reserves are designed to protect the interests of its 28 member countries (including Australia, the US, EU members, the UK and Japan) in the event of a significant supply disruption. The last time the IEA released reserves was for Hurricanes Rita and Katrina when Gulf Coast oil production and refining was severely impacted. Its reasoning this time is in response to the ongoing disruption of oil supplies from Libya.

IEA member countries agreed to make 2 million barrels of oil per day available from their emergency stocks over an initial period of 30 days.

While the situation in Libya has removed around 1.5 million barrels of oil a day, this has been the case since March/April and hence we believe the window for the IEA to act on supply disruption grounds has passed.

It seems the rationale for the IEA releasing additional reserves is economic rather than supply-related. The agency's press release stated that greater tightness in the oil market threatened "to undermine the fragile global economic recovery", and its Executive Director Nobuo Tanaka said the IEA is committed "to well-supplied markets and to ensuring a soft landing for world energy markets".

The move came after the Organisation of Petroleum Exporting Countries' (OPEC) met in Vienna on 8 June and kept production quotas unchanged as Saudi Arabia didn't find enough support from other members to boost supply. This is despite Saudi Arabia unilaterally pledging after the meeting to increase its supply by 1 million barrels of oil a day.

We understand that the Saudis have already increased supply by half a million barrels of oil a day, contributing to a relatively modest US$6 per barrel fall in the Brent crude price. We believe the IEA is sending a message that it does not believe the Saudis' production increases will be sufficient to curb prices.

OPEC's response to this insult has been swift (in rhetoric at least) with one delegate indicating the IEA move is "surprising and unjustified … the agency is acting on its own, and we don't see a need for the release of emergency stocks". Another delegate said bluntly, "if we see a glut or a fall in prices, OPEC will call an emergency meeting to correct [them]". The nature of the commentary from IEA and OPEC shows the widening gulf between the world's largest net consumers (IEA members) and net producers (OPEC).

We note that if the IEA were to release strategic reserves the move could result in an unintended increase in oil prices (after an initial downward reaction) as it sends a clear signal that the world's largest oil consumers do not believe that OPEC (and the Saudis specifically) have the ability to ramp up production to meet supply calls. We concur with this assessment, although the way in which it may unfold is a little different, with the same upside risk to oil prices in the short and medium term. We think the possibility of direct action by OPEC and Saudi Arabia to offset the reserve release with production cuts should support oil prices in the short to medium term.

Oil Supply and Demand (million barrels/day)

Supply	Production
OPEC	33.4
Non-OPEC	47.7
Processing gains	2.3
World Supply	**83.3**

Demand	Consumption
OECD	41.7
North America	21.9
Europe	12.7
Pacific	7.0
Non-OECD	35.8
E.Europe/Eurasia	4.6
Asia	16.3
Middle East	6.5
Africa	3.0
Latin America	5.3
Bunkers	6.5
World Demand	**84.0**

Source: IEA World Energy Outlook 2010. Measures demand and supply for 2009 calendar year.

St Vincent de Paul

CEO Sleep out

Armed with a cardboard mat and a sleeping bag, Ord Minnett Executive Chairman Karl Morris slept 'rough' on the South Bank Parklands in Brisbane on 16 June 2011 for the St Vincent de Paul (Vinnies) CEO Sleep out. Across the country, almost 1,000 senior business leaders took part in the fifth annual fundraising event on a cold winter's night. The CEO Sleep out event was created to highlight the plight of homelessness in Australia by challenging business and community leaders to experience the difficulties faced by over 100,000 homeless Australians every night.

Karl's efforts were generously supported with donations from friends, colleagues, staff and clients – allowing him to successfully raise nearly $30,000, the third highest amount raised in Queensland. At a time when many Australian families are having difficulty with rising living costs, Vinnies provides hope and practical solutions to assist. The money raised for St Vincent de Paul allows them to continue their good work supporting the vulnerable and forgotten in society. If you would care to donate please visit Vinnies website: www.vinnies.org.au

Change of Address

Ord Minnett Brisbane wish to advise that we will move to new office premises on Friday 22 July.

The general phone number (07) 3214 5555 and fax (07) 3214 5550 will remain unchanged.

The new Ord Minnett Brisbane office address will be:

Level 31
10 Eagle Street
Brisbane QLD 4000

GPO Box 7887
Brisbane QLD 4001

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Ord Minnett Branches

Adelaide
Level 11
11-19 Grenfell Street
Adelaide SA 5000
Tel: (08) 8203 2500
Fax: (08) 8203 2525

Brisbane
Level 31
10 Eagle Street
Brisbane QLD 4000
Tel: (07) 3214 5555
Fax: (07) 3214 5550

Buderim
Sunshine Coast
84 Burnett Street
Buderim QLD 4556
Tel: (07) 5430 4444
Fax: (07) 5430 4400

Caloundra, Sunshine Coast
79-81 Bulcock Street
Caloundra QLD 4551
Tel: (07) 5491 3100
Fax: (07) 5491 3222

Canberra
101 Northbourne Avenue
Canberra ACT 2600
Tel: (02) 6206 1700
Fax: (02) 6206 1720

Coffs Harbour
Suite 4, 21 Park Avenue
Coffs Harbour NSW 2450
Tel: (02) 6652 7900
Fax: (02) 6652 5716

Gold Coast
Level 7
50 Appel Street
Surfers Paradise QLD 4217
Tel: (07) 5557 3333
Fax: (07) 5557 3377

Mackay
45 Gordon Street
Mackay QLD 4740
Tel: (07) 4969 4888
Fax: (07) 4969 4800

Melbourne
Level 23
120 Collins Street
Melbourne VIC 3000
Tel: (03) 9608 4111
Fax: (03) 9608 4142

Newcastle
41-45 Newcomen Street
Newcastle NSW 2300
Tel: (02) 4910 2400
Fax: (02) 4910 2424

Sydney
Level 8, NAB House
255 George Street
Sydney NSW 2000
Tel: (02) 8216 6300
Fax: (02) 8216 6311

Tamworth
Suite 3
344-346 Peel Street
Tamworth NSW 2340
Tel: (02) 6761 3333
Fax: (02) 6761 3104

Wollongong
3/55 Kembla Street
Cnr Market and
Kembla Streets
Wollongong NSW 2500
Tel: (02) 4226 1688
Fax: (02) 4226 1604